

Author: Comm Jobs Econ Dev & Econ Analyst: Roger Lackey Bill Number: AB 278Related Bills: See Legislative History Telephone: 845-3627 Amended Date: 04-18-2002Attorney: Patrick Kusiak Sponsor: _____**SUBJECT:** Value Added Agriculture Land Use Economic (VALUE) Zones/MIC/Increase To 7% & Extend Repeal Date

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

☒ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED

☒ June 14, 2001, STILL APPLIES.☒ OTHER - See comments below.**SUMMARY**

This bill would:

- require the California Technology, Trade and Commerce Agency (TTCA) to designate value added agriculture land use economic (VALUE) zones,
- allow qualified taxpayers in a VALUE zone to claim certain tax incentives,
- increase the Manufacturer's Investment Credit (MIC) from 6% to 7% of the cost of certain property used in manufacturing activities, and
- extend the MIC until at least January 1, 2008.

This bill also would make changes related to the exemption of certain items from sales and use tax and the development of a website by the Employment Development Department. These provisions are not discussed in this analysis.

SUMMARY OF AMENDMENTS

The April 18, 2002, amendments added new provisions that would allow TTCA to designate five VALUE zones, and would allow VALUE zone taxpayers special income tax incentives. For purposes of the MIC provisions, the department's analysis of the bill as amended June 14, 2001, still applies. For the VALUE zone amendments added April 18, 2002, the following analysis applies.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Gerald H. Goldberg

6/4/02

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2003. However, certain provisions of the bill would be operative for taxable years beginning on or after January 1, 2001, and January 1, 2002.

POSITION

Pending.

Summary of Suggested Amendments

Department staff is available to assist the author in resolving the implementation and policy considerations addressed below.

ANALYSIS

FEDERAL/STATE LAW

Under the Government Code, existing state law provides for the designation of enterprise zones (EZs), Local Agency Military Base Recovery Areas (LAMBRA's), a Targeted Tax Area (TTA), and two Manufacturing Enhancement Areas (MEA's). Using specified criteria, the TTCA designates these economic development areas from the applications received from the governing bodies. EZs are designated for 15 years (except EZs meeting certain criteria may be extended to 20 years), and TTCA is authorized to designate 42 EZs under current law (39 currently are designated). However, when an EZ expires, TTCA is authorized to designate another in its place. Eight LAMBRA designations are authorized, at least one from each of the five regions (as specified) of the state. Currently, TTCA has designated three of the eight LAMBRAs and two other areas have received conditional designation. Each LAMBRA designation is binding for eight years. The TTA was designated November 1, 1998, and the MEAs were designated October 1, 1998. Both the TTA and MEAs are binding for 15 years beginning January 1, 1998.

TTCA may audit EZ programs and determine a result of superior, pass, or fail, and may dedesignate failing programs. Any business located in a dedesignated zone that has elected to avail itself of any state tax incentive for any taxable year prior to dedesignation may continue to avail itself of those tax incentives for a period equal to the remaining life of the EZ, provided the business otherwise is still eligible for those incentives. Once an EZ is dedesignated, it is no longer an EZ for designation purposes. Thus, once an EZ is dedesignated, TTCA may designate another EZ in its place to maintain a total of 42 EZs.

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within economic development areas. These incentives include a sales or use tax credit, hiring credit, business expense deduction, and special net operating loss treatment. Two additional incentives include net interest deduction for businesses that make loans to businesses within the economic development areas and a tax credit for employees working in an EZ. See description of tax incentives and apportioning rules in "Attachment A" (Sales or Use Tax Credit, Hiring Credit, Employee Wage Credit, Business Expense Deduction, Net Operating Loss, and Net Interest Deduction).

THIS BILL

This bill would authorize a new type of economic development area called a VALUE zone. This bill would specify that TTCA could designate only a city, county, or city and county that meets certain criteria regarding the agricultural industry, unemployment rate, and poverty levels. A designation made by the TTCA would be binding for a period of 12 years from the date of the original designation. The TTCA would be authorized to designate five VALUE zones.

This bill would provide qualified taxpayers doing business or employed in a VALUE zone the benefit of the same type of sales and use tax credit, hiring credit, business deduction, NOL deduction, and employee wage credit as taxpayers doing business or employed in an EZ. The EZ income tax benefits are discussed in greater detail in Attachment A.

This bill would define “qualified taxpayer” as including a taxpayer engaged in a trade or business in a designated VALUE zone that is described in the following lines of business in the North American Industry Classification System (NAICS):

animal production; food manufacturing; beverage and tobacco manufacturing; textile mills; textile production mills; leather and allied manufacturing; wood products manufacturing; chemical manufacturing; plastics and rubber products manufacturing; non-metallic mineral product manufacturing; primary metal manufacturing; fabricated metal product manufacturing; warehousing and storage and; research and development in the physical, engineering, and life sciences.

IMPLEMENTATION CONSIDERATIONS

The sales and use tax credit and business expense deduction provided in the MIC and proposed by the VALUE zone would be operative for taxable years beginning on or after January 1, 2002; however, this bill would not become effective until January 1, 2003. Consequently, these provisions may be interpreted as retroactive and may be considered a gift of public funds. The author may want to consider amending the bill to allow the operative date of these provisions to be applicable to taxable years beginning on or after January 1, 2003.

This bill contains language stating that the changes to the general NOL law would apply to NOLs for taxable years beginning on or after January 1, 2001. As mentioned in the previous consideration, this bill would not become effective until January 1, 2003. The author may want to consider amending the bill to allow the operative date of the general NOL changes to be applicable to taxable years beginning on or after January 1, 2003.

This bill would add several provisions to the Corporation Income Tax Law that refer to “income year.” Recent legislation replaced the term “income year” with “taxable year.” These references should be amended to “taxable year.”

It is unclear if the \$1 million sales and use tax credit limit for “qualified property” is aggregate (all items of qualified property purchased during the taxable year) or if it is \$1 million per item. Since the VALUE zone tax incentives are based on the tax incentives of the EZs, the department would interpret the \$1 million dollar limitation as being aggregate.

In addition, the \$1 million dollar limitation is silent in regard to any amounts exceeding \$1 million. Since the treatment of excess is silent, taxpayers may seek to carryover any excess "qualified property" costs to the following taxable year. However, even if a taxpayer attempted to carryover the excess amount the department would deny the taxpayer the credit since the taxpayer would be required to have paid sales and use tax during the taxable year on the "qualified property" that the credit is claimed for. Further, to be considered "qualified property" the property would have to be placed in service in the taxable year the credit is claimed. Since the excess would have been placed in service the prior year the taxpayer would also be denied the credit on any excess qualified property.

The sales and use tax credit requires that the qualified property be "exclusively" used in the VALUE zone. The recapture provision of the sales and use tax credit requires recapture of the credit if the qualified property is disposed of or is no longer used by the taxpayer in the VALUE zone. The "exclusive" requirement is interpreted to require the qualified property to only be used in the VALUE zone, while the recapture provision requires that the taxpayer no longer use the qualified property in the VALUE zone. These provisions are inconsistent. For example, after acquiring the credit the taxpayer uses the qualified property in the VALUE zone, but also uses the qualified property outside of the VALUE zone. Under the "exclusive" requirement, the taxpayer would no longer be allowed the credit. However, under the recapture provisions the taxpayer is required to no longer be using the qualified property in the VALUE zone. Since the taxpayer is still using the qualified property in the VALUE zone, just not exclusively, the taxpayer would not be required to recapture the credit. The author should consider amending the bill to allow these provisions to be consistent.

The recapture provisions of the sales and use tax credit require the recapture of the credit if the taxpayer disposes of the qualified property or no longer uses the qualified property in the VALUE zone at anytime before the close of the second taxable year beginning with the placed in service date. The department interprets similar recapture provisions to require the closure of two taxable years **after** the end of the taxable year in which the property is placed in service. For example, if a calendar year taxpayer purchased qualified property and placed the qualified property in service on June 1, 2000, the recapture period would include the 6 months remaining in the 2000 taxable year and the following two taxable years. Therefore, the close of the second taxable year would be the 2002 taxable year.

The department would be required to retain the credit carryover for the sales and use tax credit on the tax forms indefinitely because the provision adding that credit allows for an unlimited credit carryover period. Recent credits have been enacted with a carryover period limit since experience shows credits are typically used within eight years of being earned.

Once the implementation considerations are resolved, this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

TECHNICAL CONSIDERATIONS

This bill refers to the "Trade and Commerce Agency (TCA)," TCA was renamed the Technology Trade and Commerce Agency. Any reference to TCA should be amended to refer to the Technology Trade and Commerce Agency.

The personal income tax sales and use tax credit refers to "qualified taxpayer" to mean a person. It is suggested the term "taxpayer" be used in place of person

LEGISLATIVE HISTORY

AB 1977 (Reyes 1999/2000) was identical to the VALUE zone provisions of this bill. AB 1977 failed to pass out of the Assembly Appropriation Committee.

AB 462 (Briggs 1999/2000) would have created a credit of 6% of the qualified cost of qualified property for taxpayers engaged in specified warehousing and distribution activities in a qualified facility. AB 462 failed to pass out of the Assembly Revenue and Taxation Committee.

OTHER STATES' INFORMATION

Currently, 29 other states have economic development areas that allow similar tax related incentives to those provided in California's economic development areas. No specific information was found for zones similar to the VALUE zones proposed by this bill.

FISCAL IMPACT

Once the implementation considerations are resolved, implementing this bill would not significantly impact the department's programs and operations.

ECONOMIC IMPACT

Revenue Estimate

Based on the discussion below, the revenue loss from this bill is as follows:

Revenue Impact of AB278 For Taxable Years Beginning on or After January 1, 2002 Enactment After June 30, 2002 (In Millions)			
	2002-3	2003-4	2004-5
MIC	-\$40	-\$45	-\$50
VALUE Zones	Minor Loss	-\$1	-\$7
Total Revenue Impact	-\$40	-\$46	-\$57

(Minor) means losses less than \$500,000

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

Revenue Discussion

Increase MIC from 6% to 7%

The revenue impact of this provision would depend on the increased credit amounts and the tax liability of qualified taxpayers.

These estimates are based on micro-simulation models of California tax returns for tax years 1998 and 1999 and grown to approximate 2001. This estimate differs significantly from the previous estimate of this bill due to California's latest projected economic outlook. The credit use rates taken from the models were then applied to derive the aggregate credit use. The fiscal year cash flow patterns are based on the department's analysis of how manufacturers adjusted their tax payments to reflect the reduction in liability resulting from the current law MIC.

Extend the Repeal Date for MIC

It is anticipated that the MIC will not sunset under the current law requirement. Under current law MIC will sunset only if employment in manufacturing, not including aerospace, on January 1, 2001, "does not increase by 100,000 jobs the total manufacturing sector employment in this state on January 1, 1994". Employment in manufacturing increased by 204,600 between 1994 and 2001 meeting the targeted increase. It is assumed that the current law MIC will remain operative indefinitely, unless a major change in the economy occurs.

VALUE Zones

Revenue losses under the Personal Income Tax Law and the Corporation Tax law would depend on the number of VALUE zones designated in any given year and the number and apportioned tax liabilities of businesses that could take advantage of the various state tax incentives offered by the bill.

The average revenue loss in tax year 1999 for all existing EZs in the state was approximately \$2 million per EZ. The proposed zones in this bill would probably be more depressed economically. Estimates above, therefore, are general orders of magnitude for five VALUE zones authorized by January 1, 2003.

ARGUMENTS/POLICY CONCERNS

This bill would incorporate future changes to the NAICS Manual automatically since the bill does not specify the "edition" date of this publication. As a result, unintended industries or taxpayers could be subsequently included, or intended industries or taxpayers deleted, from the benefits this bill provides without further legislative action.

LEGISLATIVE STAFF CONTACT

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Attachment A
AB 278
As Amended April 18, 2002

Sales or Use Tax Credit

The sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified machinery purchased for exclusive use in an economic development area (except a Manufacturing Enhancement Area). The amount of the credit is limited to the tax attributable to economic development area income. Qualified property is defined as follows:

Enterprise Zone or TTA:

- machinery and machinery parts used for:
 - manufacturing, processing, assembling, or fabricating;
 - producing renewable energy resources; or
 - air or water pollution control mechanisms.
- data processing and communication equipment.
- certain motion picture manufacturing equipment.

LAMBRA:

- high-technology equipment (e.g., computers);
- aircraft maintenance equipment;
- aircraft components; or
- certain depreciable property.

In addition, qualified property must be purchased and placed in service before the economic development area designation expires. The maximum value of property that may be eligible for the enterprise zone, LAMBRA, and TTA sales or use tax credit is \$1 million for individuals and \$20 million for corporations.

Hiring Credit

A business located in an economic development area may reduce tax by a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated as an economic development area and meet certain other criteria. At least 90% of the qualified employee's work must be directly related to a trade or business located in the economic development area and at least 50% must be performed inside the economic development area. The business may claim up to 50% of the wages paid to a qualified employee as a credit against tax imposed on economic development area income.

The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage (under special circumstances for the Long Beach enterprise zone, the maximum is 202% of the minimum wage). The amount of the credit must be reduced by any other federal or state jobs tax credits, and the taxpayer's deduction for ordinary and necessary trade or business expenses must be reduced by the amount of the hiring credit. Certain criteria regarding who may be qualified employees and certain limitations differ between the various economic development areas.

Business Expense Deduction

A business located in an economic development area (except an MEA) may elect to deduct as a business expense a specified amount of the cost of qualified property purchased for exclusive use in the economic development area. The deduction is allowed in the taxable year in which the taxpayer places the qualified property in service. For LAMBRA businesses, the amount of the deduction is added back to the taxpayer's income if at the close of the second year the taxpayer does not have a net increase of one or more jobs (defined as 2,000 paid hours per employee per year). The property's basis must be reduced by the amount of the deduction. For enterprise zones, LAMBRAs, and the TTA the maximum deduction for all qualified property is the lesser of 40% of the cost or the following:

If the property was placed in service:

Months After Designation	Maximum Deduction
0 to 24	\$40,000
25 to 48	30,000
48 and over	20,000

Net Operating Loss Deduction

A business located in an economic development area may elect to carry over 100% of the economic development area net operating losses (NOLs) to deduct from economic development area income of future years. The election must be made on the original return for the year of the loss. The NOL carryover is determined by computing the business loss that results from business activity in the economic development area.

Net Interest Deduction

A deduction from income is allowed for the amount of net interest earned on loans made to a trade or business located in an enterprise zone. Net interest is defined as the full amount of the interest less any direct expenses (e.g., commission paid) incurred in making the loan. The loan must be used solely for business activities within the enterprise zone, and the lender may not have equity or other ownership interest in the enterprise zone trade or business. This incentive is not available for LAMBRAs, the TTA, or MEAs.

Enterprise Zone Employee Wage Credit

Certain disadvantaged individuals are allowed a credit for wages received from an enterprise zone business. Public employees are not eligible for the credit. The amount of the credit is 5% of "qualified wages," defined as wages subject to federal unemployment insurance. For each dollar of income received by the taxpayer in excess of qualified wages, the credit is reduced by nine cents. The credit is not refundable and cannot be carried forward. The amount of the credit is limited to the amount of tax that would be imposed on income from employment in the enterprise zone, computed as though that income represented the taxpayer's entire taxable income. This incentive is not available for LAMBRAs, the TTA, or MEAs.

Apportioning

For businesses operating inside and outside an economic development area, the amount of credit or net operating loss deduction that may be claimed is limited by the amount of tax on income attributable to the economic development area. Income is first apportioned to California using the same formula as that used by all businesses that operate inside and outside the state (property, payroll, a double-weighted sales factor). This income is further apportioned to the economic development area using a two-factor formula based on the property and payroll of the business.